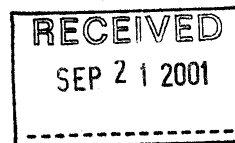




DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

September 21, 2001



MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: *John M. Dalrymple*
John M. Dalrymple
Commissioner, Wage and Investment Division

SUBJECT: *for* Draft Audit Report – "Initial Electronic Filing of Partnership Returns Was Successful, But Additional Checks Are Needed To Ensure the Accuracy of Information From These Returns Used in the Matching Programs" (Audit No. 200030040)

Thank you for the opportunity to review and comment on the subject draft report. I am pleased your draft report acknowledges that we successfully implemented the processing of electronically filed partnership returns and related Schedules K-1. The report also accurately describes our immediate actions to correct problems identified early in the processing.

As part of the Electronic Tax Administration's (ETA) mission to revolutionize how taxpayers transact and communicate with the IRS, our goal is to deliver the highest quality products and services to taxpayers. Accordingly, we have identified the actions we plan to take to improve the accuracy of information taxpayers provide on electronic Form 1065, U.S. Partnership Return of Income, and Schedule K-1, Partner's Share of Income, Credits, Deductions, etc. Our specific comments to the findings and recommendation stated in your draft report follow.

IDENTITY OF RECOMMENDATION/FINDING #1:

The ETA Function, along with the Compliance Function, of the Small Business/Self-Employed (SB/SE) Division, and the Pre-Filing and Technical Guidance Function, of the Large and Mid-Sized Business (LMSB) Division, should develop controls to ensure the accuracy of Forms 1065 and Schedules K-1 and improve the success of the matching programs. Primary consideration should be validity checks for taxpayer identification numbers on Forms 1065 and Schedules K-1 and checks to ensure tax data from Forms 1065 are in agreement with the sum of corresponding figures reported on the individual Schedules K-1.

ASSESSMENT OF CAUSE:

Electronically filed returns have the potential for being more accurate than paper returns because the IRS can perform certain validity checks before accepting the returns.

However, we do not include validity checks in the current e-file system to determine if partner taxpayer identification numbers (TINs) are valid or to ensure that data reported on the Form 1065 or the Schedule K of the Form 1065 agrees with the sum of corresponding figures reported on the individual Schedule K-1.

CORRECTIVE ACTIONS:

We agree that improving correct matching and accuracy is a desired organizational goal. However, implementing this recommendation would require cross-organizational actions because required changes not only involve electronically filed Forms 1065 and Schedules K-1, but all Forms 1065 and Schedules K-1, including paper filed returns for all types of tax returns (trusts, S Corporations, etc.).

In addition, we have established a Form 1065 Executive Steering Committee of representatives from the Wage and Investment, SB/SE, and LMSB Operating Divisions. One task of the Committee was to address the math and TIN verification of Schedules K-1. As such, they made the following decisions:

Validity Checks for TINs on Forms 1065 and Schedules K-1

We will not implement additional validity checks to determine whether TINs are valid for Processing Year (PY) 2002 just because very few Schedules K-1 have incorrect TINs. It would not be practical to reject an electronically filed Form 1065 with many Schedules K-1. Partners do not always provide partnerships with their TINs, and the TINs they provide are sometimes incorrect. Unlike information returns, where a payer has the threat of backup withholding to persuade partners to provide their TIN, a partnership has no way to compel its partners to provide correct TINs. Partners or partnerships that cannot file electronically are eligible for a waiver from the requirement to file electronically. This would increase the paper filing of the Form 1065 and the Schedule K-1. Without up-front verification of TINs on paper returns, the IRS would accept these invalid TINs.

For the first year of the mandated e-file program, we wanted to help filers comply. Therefore, we performed minimal up-front TIN validation. We accepted the returns electronically and worked the TIN issue as part of the backend processes. As the 1065 e-file program continues to mature, we may adjust specific validations and tolerances. In PY 2002, SB/SE and LMSB Operating Divisions will sample both paper and electronic returns to determine the extent of the problem. Afterwards, they will consider rejecting returns in which invalid TINs are present and consider assessing penalties against partnerships and partners.

Matching of Amounts from Form 1065 or the Schedule K of the Form 1065 to the Schedule K-1

We will not implement math verification of data from the Form 1065 or the Schedule K of the Form 1065 to determine if they agree with the sum of corresponding figures reported on the individual Schedules K-1. Instead, we will accept returns electronically when amounts do not match. In PY 2002, SB/SE and LMSB Operating Divisions will conduct a review to determine the extent of the problem. We would probably not reject returns due to mismatches, but we may notify partners of problems in subsequent processing years.

According to external stakeholders, in the typical Publicly Traded Partnership (PTP), the sums of the amounts reported on the Schedule K-1 exceed the amounts reported on Schedule K. This is the result of the manner in which the brokerage/nominee community provides beneficial owner information to PTPs under Section 6103(c). If we rejected returns because of these discrepancies, we would create difficulties for the partnership trying to comply with the mandate to electronically file. Non-PTPs may also have mismatches in amounts due to a variety of valid reasons.

In addition, we do not validate TINs up-front and do not compare Schedule K and Schedule K-1 for paper filed returns. To date, we have tried to treat electronic and paper returns the same in terms of validation. To do otherwise would impose an additional burden on filers of the electronically filed returns. Although we will still require large partnerships to file electronically, this would discourage the voluntary electronic filing of Form 1065. This could adversely impact us in fulfilling the IRS Restructuring and Reform Act of 1998 to have at least 80 percent of all returns filed electronically by 2007.

RESPONSIBLE OFFICIALS:

Commissioner, Wage and Investment Division
Director, Electronic Tax Administration Division
Director, Diversified Electronic Filing Division

Commissioner, Small Business/Self-Employed Division SB/SE
Compliance Function

Commissioner, Large and Mid-Sized Business Division LMSB
Business Systems Planning Function

IMPLEMENTATION DATE: N/A

If you have any questions, please contact Sherrill Fields, Director, Diversified Electronic Filing Division, at (202) 283-4872.